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Ex Parte

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Marlene H Dortch
Secretary
Federal Communications Commission
445 12th Street, SW
Washington, DC 20554

Re *Verizon Petition for Forbearance from the Prohibition of Sharing Operating, Installation, and Maintenance Functions Under Section 53.203(a)(2) of the Commission's Rules*, CC Docket No 96-149

Dear Ms. Dortch:

Verizon has already demonstrated that its petition for forbearance from the prohibition of sharing operating, installation, and maintenance ("OI&M") services between the Verizon BOCs and their section 272 affiliates is in the public interest. AT&T's July 9 *ex parte* letters repeat many of its previous criticisms and they completely fail to refute the public policy and legal rationale for Commission approval of Verizon's petition Indeed, Verizon has already responded to most of AT&T's arguments in its previous filings This filing responds to a few additional AT&T arguments that are equally without merit.

Despite Verizon's repeated explanations of its costing methodology, AT&T continues to misconstrue Verizon's cost study submitted in support of the forbearance petition. AT&T incorrectly claims that Verizon assumed that the BOCs have excess capacity in their OI&M workforce and would incur no incremental costs to provide OI&M services to their section 272 affiliates Based on this mischaracterization, AT&T claims that Verizon would not comply with the Commission's cost allocation rules in allocating costs between its regulated and non-regulated services. In fact, Verizon made no such assumption. Its cost study includes a reasonable estimate of the incremental costs that the BOCs would incur to provide OI&M services to the section 272 affiliates These costs are lower than the costs that the section 272 affiliates currently incur due to the greater economies of scale that the BOCs enjoy as compared to the section 272 affiliates The study confirms the Commission's repeated findings that separate affiliate

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requirements impose substantial cost burdens that could be avoided through integrated operations

1. **Verizon has not assumed that the BOCs would "absorb" the OI&M work for the section 272 affiliates without incurring additional costs.**

AT&T argues (Selwyn Decl , ¶¶ 11-13) that Verizon's cost study is based on an "absorption" theory that is contrary to TELRIC-based pricing because it assumes that the BOC would provide OI&M services to the section 272 affiliate using idle BOC personnel at essentially zero incremental cost AT&T claims that this is a short-run marginal cost approach that would produce transfer prices to the section 272 affiliate below the BOC's long run cost of providing OI&M services There are two fundamental flaws in this argument. First, TELRIC costing principles, which the Commission adopted for the pricing of unbundled network elements under section 252 of the Act, have no relevance to the pricing of access services or to the affiliate cost allocation rules, which are based on fully distributed cost principles Second, Verizon did not assume that the BOCs have excess capacity or that the costs of providing OI&M service would be zero, as AT&T claims Rather, the OI&M costs that Verizon shows in its study as *not* being saved are primarily the costs that the BOC would incur to provide these services to the section 272 affiliate These are long-run costs, not short run. They are lower than the costs that the section 272 affiliate currently incurs, because the BOCs could provide these services more efficiently due to their much greater economies of scale as compared to the small OI&M forces employed by the section 272 affiliates.

For instance, there would be no need for a separate section 272 maintenance work group if the BOCs could perform maintenance for both themselves and for the section 272 affiliates. Verizon estimated that the BOCs could perform the maintenance function by adding expenses equal to only 70 percent of the costs that the section 272 affiliates currently incur due to the much greater economies of scale enjoyed by the BOCs The section 272 affiliates cannot operate as efficiently as the BOCs, because they must assign dedicated personnel to be available for installation, maintenance and repair of facilities even if these personnel are not fully utilized. In addition, since it would be impractical for the section 272 affiliates to deploy a field force and supporting assets, such as trucks and other equipment, to install and repair the relatively small amount of outside plant, they must rely upon more costly independent contractors for the outside plant function on an as-needed basis Use of the BOC field force would allow the section 272 affiliates to replace the use of outside vendors for this purpose and avoid most of these costs (categorized as "professional services")

For the same reasons, AT&T is incorrect in claiming (Selwyn Decl , ¶¶ 14, 18-19) that Verizon would violate the Commission's Part 64 cost allocation rules by failing to allocate BOC OI&M expenses to the section 272 affiliates at fully distributed cost AT&T assumes that the BOCs would allocate next to nothing to nonregulated accounts for these OI&M services. This is incorrect. As Verizon explained in its June 24 *ex parte* filing, if the Commission granted OI&M forbearance, Verizon would file Cost Allocation Manual ("CAM") changes to capture these costs, using time reporting codes and new non-regulated cost pools as necessary. ***See*** June 24 *ex parte*, 4-5 Similarly, AT&T's assumption (Selwyn Decl , ¶ 18) that Verizon would engage in "non-zero" allocations of costs of investment used jointly for regulated and non-regulated activities is baseless Such investments would be allocated using fully-distributed cost principles based on relative use

2. Verizon would have no incentive to misallocate OI&M costs to the BOCs.

AT&T alleges (Selwyn Decl., ¶ 7, ***see also*** AT&T Opposition, Selwyn Decl., ¶ 35) that Verizon has several incentives, even under a pure price cap regime, to misallocate costs to the BOC and to artificially lower the section 272 affiliate's costs However, these arguments are based on the incorrect assumption that Verizon's cost study is based on substantial excess workforce at the BOC that could be made available to the section 272 affiliate at little or no cost. As Verizon explained above, this just is not so Verizon did not assume idle hands at the BOC. It simply took advantage of the greater economies of scale and efficiencies that the BOC could bring to bear in providing these services to the section 272 affiliates as opposed to the costs that are currently incurred by the section 272 affiliates in maintaining small, dedicated workforces. Consequently, AT&T's assumption that the BOC has "large quantities of excess or spare capacity" that are inflating the BOCs' costs for regulated service is wrong. The incremental cost that the BOCs incur to provide OI&M services to a section 272 affiliate will be charged to that affiliate on a fully distributed cost basis

AT&T provides three examples to support its claim that Verizon has an incentive to misallocate costs even under price caps. None of these makes any sense. First, AT&T argues that the BOC spare capacity costs could be used to justify higher prices for "bottleneck" services such as access and UNEs. However, access service prices were initialized in 1990 and have been adjusted ever since by a price cap formula using "X-factors" and inflation adjustments that are indifferent to the price cap carrier's actual costs The 1990 rates were established under rate of return after a thorough review by the Commission. There is no evidence that these rates were inflated by "excess capacity " With regard to UNEs, those rates are set using the "TELRIC" methodology, which is based on hypothetical costs rather than on Verizon's actual costs. Second, AT&T argues that shifting costs to the regulated operation lowers the long distance affiliate's costs and makes it easier for the affiliate to compete with "downstream" rivals, presumably because the affiliate would not pay the full cost of the BOC's OI&M services. But Section 272(c) would require the BOC to make these services available to unaffiliated carriers under the same terms and conditions, making the same efficiencies available to the rivals as well Therefore, there is no way that the BOC could give an unfair competitive advantage to its section 272 affiliates Allowing such sharing would put Verizon's affiliated long distance carriers on the same footing as other long distance providers, who may provide local and long distance service using a single workforce Third, AT&T argues that shifting costs to the BOC would allow it to maintain or increase its access charges once the CALLS freeze has expired, or if access charges are reinitialized for a state price cap plan This is pure speculation. In the CALLS proceeding, the Commission extended for five years the market-based approach that it adopted in the access charge reform proceeding *See Access Charge Reform*, 15 FCC Rcd 12962, ¶ 60 (2000) AT&T provides no support for the proposition that the Commission will undo its own reforms at the end of the CALLS transitional period More fundamentally, the speculation that this Commission or a state commission may alter their regulatory regime is far too attenuated for it to gain any credibility for AT&T's well-worn (but never substantiated) claims of cost misallocation.[1] Moreover, the additional competition from wireline carriers as well as from alternative platforms such as cable and wireless eliminate any ability of the BOCs to raise rates for local or exchange access services unreasonably, even if the regulators were to allow such changes.

3. The Verizon BOC would provide OI&M services to unaffiliated entities on a non-discriminatory basis.

AT&T argues (Selwyn Decl , ¶ 21) that Verizon would violate the nondiscrimination requirements of section 272(c) of the Act by providing the efficiency gains of OI&M services only to its section 272 affiliates. This simply is not true The BOC charges for OI&M services to the section 272 affiliates would be the "prevailing price" that would also be offered to non-affiliated companies. *See* 47 C.F R § 32 27(d). Section 272(b)(5) of the Act and section 53 203(e) of the Commission's rules require the BOCs to develop arms-length, written contracts with their section 272 affiliates and to make those contracts available for public inspection The same services, at the same prices, will be available to third parties For example, the Verizon BOCs currently provide billing and collection services to their section 272 affiliates as well as to non-affiliated long distance carriers on a non-discriminatory basis

4. Verizon has explained and justified the basis for its estimates of the percentages of each OI&M expense category that it could save through forbearance.

AT&T repeats its previous arguments (Selwyn Decl , ¶ 4) that Verizon has not justified its estimates of the percentages of each OI&M expense category that it could save through forbearance by having the BOCs provide OI&M services to the section 272 affiliates. AT&T complains that it cannot reproduce these percentages and that Verizon has not produced facts by which these percentages were calculated. These criticisms are not valid By necessity, these estimates are based on the expert judgment of the Verizon subject matter experts in each field. *See* Attachment, ¶ 3. Verizon currently operates under the OI&M restrictions, and its detailed financial data accounting works within that regime. In order to provide the Commission with additional information about the order of magnitude of the harm caused by these restrictions, Verizon asked the subject matter experts in the section 272 affiliates to estimate the costs that would have been incurred if they had been able to ask the BOCs to perform the OI&M services

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[1] Like the Commission, the vast majority of states have adopted price cap approaches *See* Communications Daily, Retail Rate Regulation of Local Exchange Providers in the U S , A Special White Paper Supplement to Communications Daily (June 20, 2003) This white paper describes the type of price cap or incentive regulation that Verizon faces in each of its in-region states The Commission should note that in Indiana, where the report states that Verizon's rates are under non-indexed price caps, Verizon's rates are still subject to rate-of-return regulation but Verizon recently proposed an alternative form of regulation

rather than to develop a separate workforce or hire outside contractors *See* June 24 *ex parte* at 7 The subject matter experts also estimated the future timetable for transitioning from a separate workforce to use of BOC personnel for OI&M work This transition estimate was the basis for Verizon's estimate that it could save $183 million through 2006 if the forbearance petition were granted *See* June 4 *ex parte*, Attachment 3 at 5, Attachment 4 at 2. The use of such expert testimony is common in Commission proceedings, and Verizon has provided detailed information about how that testimony was used to derive the estimated cost savings. The fact that the estimates were based on expert judgment does not make them any less reliable

Regardless of the exact level of the savings that Verizon would achieve by eliminating duplicative OI&M workforces at both the BOCs and the section 272 affiliates, it is undeniable that separate affiliate requirements impose significant additional costs. The Commission has found that this is so on numerous occasions For instance, in removing the separate affiliate requirement for the provision of enhanced services, the Commission found that "the structural separation requirements impose significant costs on the public in decreased efficiency and innovation that substantially outweigh their benefits in limiting the ability of AT&T and the BOCs to make unfair use of their regulated operations for the benefit of their unregulated, enhanced services activities." *Amendment of Sections 64.702 of the Commission's Rules and Regulations (Third Computer Inquiry),* 104 F C C.2d 958, ¶ 3 (1986).

AT&T claims (at 5-8) that the Commission has found that the benefits of separate affiliates outweigh the costs where the BOCs have control of essential facilities necessary for competition This is revisionist history AT&T cites the Commission's initial decision to require the BOCs to use separate affiliates to offer customer premises equipment ("CPE"), but it conveniently neglects to mention the Commission's decision a few years later to *eliminate* this requirement *See Furnishing of Customer Premises Equipment by the Bell Operating Telephone Companies and the Independent Telephone Companies*, 2 FCC Rcd 143 (1987). In doing so, the Commission specifically found that,

> structural separation requirements impose substantially greater costs on carriers and ratepayers than nonstructural safeguards. . the loss of possible efficiencies here because of mandatory structural separation results in higher prices and reduced quality and variety of regulated services provided to ratepayers by carriers. These requirements also prevent the BOCs from satisfactorily serving customers that desire integrated telecommunications systems solutions and designs [2]

These findings confirm Verizon's demonstration that the OI&M restriction imposes substantial costs on Verizon's provision of long distance services.

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[2] Id , ¶ 29 (footnotes omitted)

have made it clear that an agency cannot refuse to follow congressional mandates based on doubts about their constitutionality *See, e.g., Johnson, Administrator Of Veterans' Affairs, et al v. Robison*, 415 U S 361, 368 (1974) ('adjudication of the constitutionality of congressional enactments has generally been thought beyond the jurisdiction of administrative agencies"); *Meredith Corp v. FCC*, 809 F 2d 863, 872 (D C Cir 1987) ("regulatory agencies are not free to declare an act of Congress unconstitutional") Only the courts may address the constitutionality of the Act

Sincerely,

Dee May

Attachment

cc J Carlisle
M Carey
B Olson
R Tanner
W Dever
R Kaufman
C Rand
M Stephens
P. Megna

Supplemental Declaration of Fred Howard

1 My name is Fred Howard I am the President of Verizon Global Networks Inc (GNI) I previously submitted a declaration in support of Verizon's August 5, 2002 petition for forbearance from the prohibition of sharing operating, installation and maintenance (OI&M) services between a Bell Operating Company and a section 272 separate affiliate (CC Docket 96-149). Information regarding my background and responsibilities are detailed in the August 5, 2002 declaration.

2 My responsibilities still include the oversight of the activities to support GNI's input to Verizon's OI&M petition In this regard, I have first-hand knowledge of the content of the cost/savings data and of the analysis provided by Verizon in its *ex parte* filings in this proceeding, including the following:

- May 12, 2003 – the historic data underlying Verizon's study of the costs of complying with the section 272 separate affiliate rules.
- June 4, 2003 –the detailed narrative of Verizon's method of calculating the going-forward savings in Attachment 3, and the historic cost data and the projected cost data in Attachment 4.
- June 24, 2003 – the OI&M functions used for expense categorization (section 1), the assumptions underlying estimates of incremental operating expenses driven by structural separations (section 4), the assumptions underlying GNI's projected expenditures for 2003-2006 period (section 5), the assumptions underlying estimates of the projected cost savings for 2003-2006 from the elimination of

structural separations (section 6), and the costs of reintegrating the OI&M functions of GNI and the Verizon local exchange carriers (section 7).

These filings were prepared under my direction and control, and I affirm that they accurately represent the basis for and procedures used in Verizon's cost study

3 AT&T complains (Selwyn Decl , ¶ 4) that it cannot reproduce the percentages that Verizon used in the cost study and that Verizon has not produced the facts by which these percentages were calculated These criticisms are not valid Since Verizon's current business plan and budget are based on the existing regulations, in preparing our estimates for cost savings associated with FCC forbearance of the OI&M restrictions, GNI relied on a review by GNI subject matter experts to determine the savings that could be achieved in the absence of the OI&M restriction. Verizon asked the subject matter experts in each job function to estimate the costs that would have been incurred if they had been able to ask the BOCs to perform the OI&M services rather than to develop a separate workforce or hire outside contractors. This process is described in the June 24 *ex parte* at 7-9. The subject matter experts also estimated the future timetable for transitioning from a separate workforce to use of BOC personnel for OI&M work. This is described in the June 24 *ex parte* at 11-12 This transition estimate was the basis for Verizon's estimate that it could save $183 million through 2006 if the forbearance petition were granted ***See*** June 4 *ex parte*, Attachment 3 at 5, Attachment 4 at 2. The fact that the estimates were based on expert judgment does not make them unreliable Verizon has provided detailed information about how the estimates were developed and how they related to the operational characteristics of each function For instance, Professional Services expenses consist primarily of field forces and contract employees

that were hired by GNI because it did not have the ability to hire employees with the required skill sets quickly enough as demand grew and because it did not have enough outside plant facilities to justify a dedicated field force This over-dependence on vendor-supplied labor would not have been necessary if Verizon could have used BOC personnel, which had both the necessary skill sets as well as the ubiquitous presence to perform OI&M services for GNI on an as-needed basis. These factors fully explained the much higher percentage of savings that GNI could achieve in the Professional Services category as compared, for instance, to the Force and Employee-Related category.

4 AT&T also complains that Verizon's analysis does not indicate that the Verizon BOC OI&M experts were consulted. (***See*** AT&T July 9, 2003 Ex Parte, Declaration of Lee Selwyn at ¶ 5.) As I explained in my August 5, 2002 declaration, the purpose of the analysis was to develop estimates of the costs that GNI has incurred and anticipates to incur to comply with the Commission's separate affiliate rules Verizon's June 24, 2003 *ex parte* (section 4) described the study team that developed those estimates, which consisted of GNI subject matter experts representing Operations, Information Technology, Engineering, Business Services and Finance. These experts are very familiar with the BOC's operations and are capable of determining the type of OI&M support they could obtain They are also capable of determining how much more efficiently these services can be provided through the large and ubiquitous BOC workforce compared to the relatively small number of GNI personnel Although the Verizon petition was reviewed by BOC representatives, it was not necessary to include BOC operational personnel in the development of the cost study, because the study did not rely on an analysis of the current BOC workforce utilization. Rather, it was based on

functional knowledge of BOC operations and capabilities to determine the ability of the BOC to provide the necessary OI&M services to GNI.

5 AT&T's criticism on this point is based on its belief that Verizon assumed that the BOC could provide OI&M services to GNI at *no* additional cost – *i.e.*, that the BOC is working inefficiently and that it would provide OI&M services using workers that are currently idle. ***See, e.g.,*** Selwyn Decl., ¶¶ 9-13. This simply is not true Verizon did not assume that the BOC is saddled with under-utilized personnel and that GNI could reduce its expenses without any increase in BOC costs. Rather, Verizon assumed that the increase in BOC costs, which would be charged to GNI under the affiliate transaction rules, would be significantly less than the costs that GNI currently incurs using a stand-alone workforce, because this workforce cannot be utilized as efficiently as the BOC's much larger workforce For instance, Verizon estimated that GNI's budget for Workforce and Empoyee Related expenses would be only 70 percent of the current level if those functions were provided by the BOC and billed to GNI by the BOC, including replacement of almost all of the work that GNI contracts today to outside vendors in the category of Professional Services expenses. The assumption was that the BOC could perform these services more efficiently because its vastly larger workforce could handle additional jobs for GNI without having to dedicate employees specifically to GNI facilities as GNI does today GNI must have employees or contractors available for installation, repair and maintenance even if they are not fully utilized due to the limited amount of switching and transmission facilities that GNI owns. By purchasing OI&M services from the BOC, GNI could take advantage of the BOC's economies of

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scale and scope These economies are shown in the net reduction in GNI's projected budget with OI&M relief.

I declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct to the best of my knowledge and belief

Executed on August 11, 2003

Fred R. Howard
Fred Howard